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### How Asia's reserve accumulation might affect the euro

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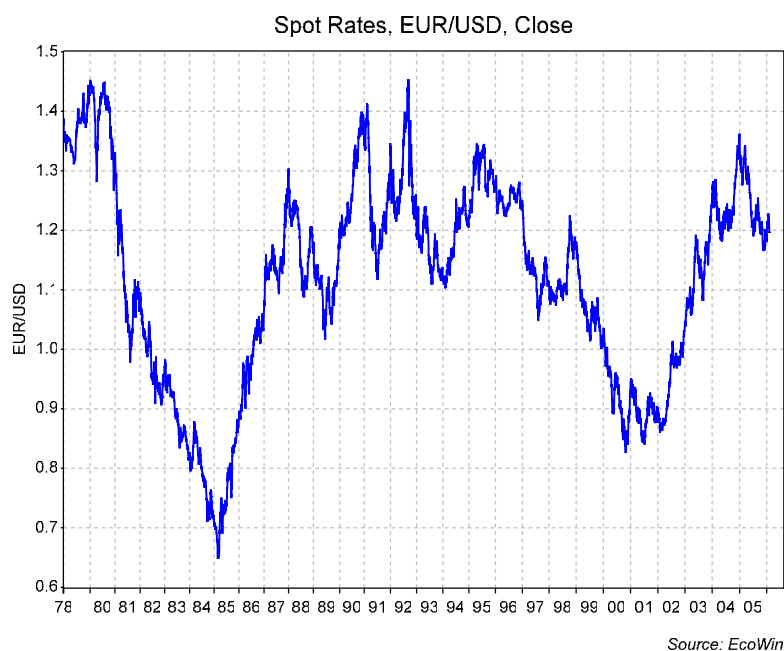
Since its introduction, the euro has become the second most important reserve currency worldwide. Although it cannot yet be compared to the dollar in terms of its importance as an international currency, the euro's future in international financial markets is bright, and its position in foreign currency reserves is likely to only strengthen with time. According to IMF statistics, the euro's share in total currency reserves rose from 17.9% in 1999 to about 25% in 2004. The dollar had its apotheosis in 1999, when it still accounted for 71% of worldwide reserves. The establishment of the euro as the second most-commonly used reserve currency has come mainly at the expense of the yen, and only marginally to the detriment of the dollar, which still accounted for two-thirds of worldwide reserves in 2004. The euro greatly benefited from its rapid appreciation vis-à-vis the dollar over the 2001-05 period, which culminated in an exchange rate of 1.36\$/€ at end-2005 (see Graph 1).

Nowadays, the euro has an especially prominent role as a reserve currency in the new EU Member States (which retain their own currencies) and other neighbouring countries. Its emergence as the second most important currency in international reserves also reflects the predominant trading patterns observed today in international commerce, as countries typically prefer to weight the holdings of their currency reserves such that the holdings more or less mirror the importance of trading partners to the domestic economy. Nevertheless, emerging economies in particular have been reluctant to accumulate a weighting of euro-denominated assets that truly reflects the EU's importance in the global economy, still disproportionately favouring US dollar denominated reserves, probably due to the liquidity edge enjoyed by the latter.

Despite the liquidity advantage of the dollar, European financial markets can today rival the US in terms of depth, breadth and liquidity, following monetary union and policy initiatives to deepen financial integration, such as the Financial Services Action Plan. As a result of these policy changes, which enhance the attractiveness of the euro as a vehicle/reserve currency, the latter has emerged as a credible alternative to the US dollar as a global forex reserve while not yet truly being regarded as an equal.

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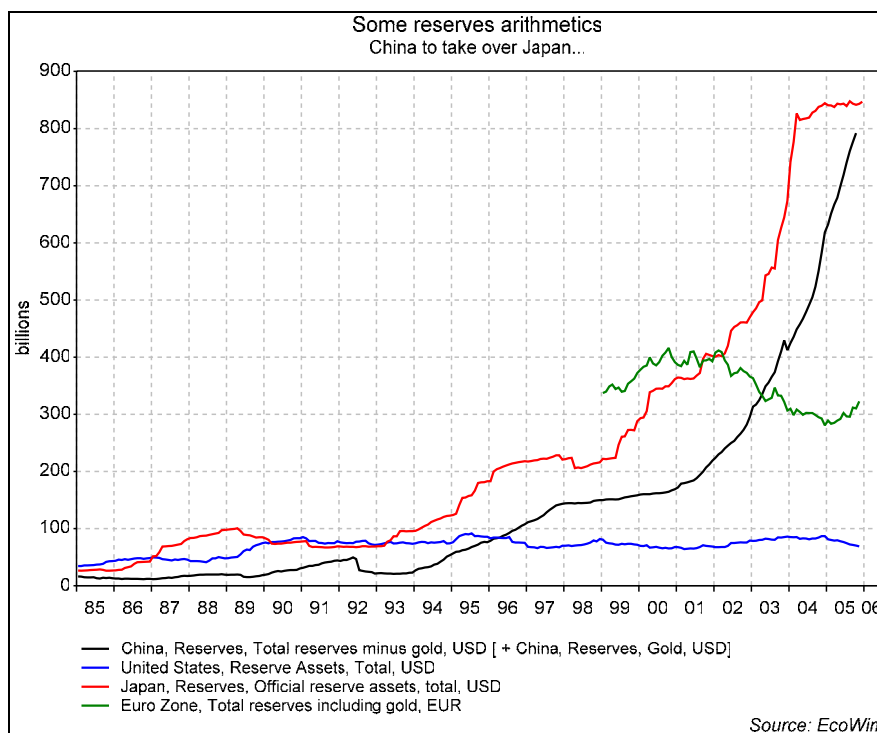
Given the sustained strength of the euro and the dangerous imbalances threatening the American economy, the continued massive build-up of foreign currency reserves throughout the world (especially in those countries hit by the financial crises of the late 1990s, particularly in Asia) presents an opportunity for the euro to increase its share in forex reserve holdings worldwide. An interesting stylised fact about central bank reserve management is that central banks typically tend to reduce reserve holdings of the dollar as it weakens. As a result, it seems that the euro will only be able to compete on equal footing with the dollar if Asian central banks start considering the euro in greater earnest as if it continues to appreciate vis-à-vis the dollar. Most East Asian economies and more commonly developing countries have traditionally relied on the dollar to maintain their pegged exchange rate regime. By contrast, it is rarer for currencies to be pegged to the euro, and these regimes tend to be extremely close to the eurozone in geographical and economic terms. At this stage, it is difficult to predict whether the euro will occupy an ever larger share in Asian central bank reserve holdings. In basing predictions on the stylised facts presented above, one must be cautious, since movements in foreign exchange markets are notoriously difficult to predict: there is hardly a forecaster who could have imagined a year ago that the position of the dollar vis-à-vis the euro would be stronger today.

Increasing international pressures on China to let its currency float has led to a modest appreciation of 2% of the yuan against the dollar in June 2005 as the PRC's central bank loosened the forex regime ever so slightly. More importantly, the national bank redefined the currency basket underlying the yuan peg with a diversification away from the dollar, so as to reduce exposures to the large anticipated dollar depreciation, as well as to reflect more accurately its trading patterns. In all likelihood, it is the euro that will benefit the most from the Chinese policy to increasingly diversify its foreign exchange reserve holdings.

Since the precise composition of Chinese foreign reserves holdings and the currency basket to which the yuan is pegged are kept a state secret, it is difficult to estimate what the magnitude of a diversification in reserve holdings by the Chinese would likely be. Nevertheless, one can be sure that an uncontrolled sell-off of the US dollar is unlikely: the impact on East Asian central banks' balance sheets would simply be too severe, and it would not be in the interest of these countries to participate in such a sell-off.

Effectively, the huge reserves built up by central banks means the latter are hostages of their own success in an environment when the unsustainability of the US current account deficit raises important question marks about the value of the dollar.

It is therefore likely that the shift away from U.S. dollar investments by Asian central banks will evolve ever so smoothly, as they diversify holdings on new inflows of reserves without necessarily changing the structure of forex reserves already sitting in their coffers. Chinese officials have publicly confirmed that no major shift away from the dollar is in sight.



More interestingly, the very rapid accumulation of foreign exchange reserves by Asian central banks (see Graph 2), particularly in Japan and China, begs the question of how these reserves are invested. Undoubtedly, the liquidity offered by US Treasuries is enticing and leads most investments to be placed in that market or in other large, developed country sovereign issues. Yet rumours have arisen recently concerning the Chinese central bank's placements in corporate bonds in the US and in the EU. Typically, central banks will refrain from investing reserves in risky assets, since liquidity is a must, and they are keen to avoid losing invested principal (and therefore their reserves). Yet the sheer massiveness of the reserve war chests built up by Japan and China in particular has raised questions about the extent to which some of these reserves are allowed to roam free on a constrained "yield hunt", particularly as the Chinese exchange rate regime is likely to be liberalised gradually. In this context, such huge reserves earning low returns may not be economically optimal. The old stylised fact that central banks will only invest in US government bonds or other OECD government bonds may therefore be less accurate today in light of the events in Asia and the ongoing transformation of financial markets.

One thing is certain: central banks in East Asia and around the world may soon be prepared to sacrifice the liquidity edge still enjoyed by US Treasuries over the euro, if it continues to be accompanied by the risk of holding an asset whose medium-term value is severely jeopardised by enormous external imbalances. The euro is the most likely currency to benefit from this trade-off once it becomes too pronounced.